Chapter 7: Retirement Plans

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

EMPLOYER-BASED RETIREMENT PLANS

Because the baby-boomer generation is quickly entering retirement, an emphasis on retirement needs is facing public and private employers and employees. The tax practitioner must understand various options and strategies used to attract and retain experienced talent. The practitioner must also understand the funding and taxation of employee benefits and postemployment benefits.

Formal, employer-based retirement planning appears in four general areas:

1. **Nonqualified plans** are those that are currently nondeductible by the company. They are not taxable to the participant until received or available to the employee. They provide a "pay later" promise. They generally become deductible by the company and become income to the participant at the time of payment. These plans are governed by IRC §409A.
2. **Qualified plans** are those that meet the rigors of §401 and are currently deductible by the employer when funded. They are not taxed to the individual until the funds are distributed. These plans are the ubiquitous variety of defined contribution and defined benefit plans familiar to the tax practitioner and marketed by investment consultants and brokers. These plans are governed by IRC §401.
3. **Share value plans** are statutory. They are known as qualified incentive stock options (ISOs), nonqualified stock options (NQs), stock appreciation rights (SARs), and employee stock ownership plans (ESOPs). They are a form of deferred compensation. Their use may be deductible by private- and publicly-traded corporations as wages. They may also be treated as nondeductible contributions of capital or as pension or profit-sharing contributions. Options, stock, and rights plans are de facto deferred compensation plans because the plan's design usually hinges on long-term performance of the company's private stock offered to the public in an initial public offering, or publicly-traded stock of an existing public corporation. These plans are governed by IRC §§409 and 421.
4. **Postretirement health care benefits** are offered in either a defined contribution plan (account balance), or the traditional defined benefit plan coverage (for life). Traditional lifetime postretirement benefits are being carefully studied in order to limit lifetime benefits. These benefits are governed by IRC §106.

NONQUALIFIED DEFERRED COMPENSATION PLANS (NQDC)

The use of nonqualified plans has become much more prevalent in small business, governments, and tax-exempt organizations since the early 1990s. This is because they offer several opportunities that offset the initial disadvantage of being nondeductible by businesses in the year promised or funded. Primarily, nonqualified plans allow:

- Selection of individual participants that does not require the universal coverage required by qualified plans. This permits disparity in contributions based on dollar amount, rate of contribution, payout timing, and age.
- Contractual obligations to be tied to postemployment actions. These can include noncompetition clauses or continued association with the former employer, which can lead to a competitive advantage.

The essence of deferred compensation is not a new concept. Deferred compensation has its roots in the constructive receipt doctrine[1] which states:

> *Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.*

Rev. Procs. 91-64 and 91-65 provide model language for plans and provide a way to obtain a ruling request on particular deferred compensation plans. The concept of a **rabbi trust**[2] was introduced, permitting the accumulation of earmarked deferred compensation assets to be utilized in paying out the plan. While this concept fell short of "funding the plan" by creating a separate and distinct pool of assets, it nevertheless withstood the challenges of "funding" provided the assets were still available to the company's general creditors in bankruptcy. This concept gave the participant some control over the time and form of payment he might expect in the future.

> **Example 1.** Bob, realizing his final four years on the job will be taxed at the highest bracket, approaches his employer to restructure his at-will employment arrangement. The employer, happy to keep a seasoned employee in a competitive marketplace, agrees to fund $20,000 per year in a nonqualified deferred compensation plan payable to Bob three years after he retires. The plan is subject to Bob honoring a noncompete agreement. The employer agrees to set aside $20,000 per year in a variable annuity contract or life insurance policy of Bob's choice. The only requirement is that the owner of the financial instrument and the beneficiary must be the company.
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> Bob is interested in an annuity or life insurance policy because it will provide him with a guaranteed benefit at a specific point in time. It is maintained by a financial intermediary. The money is separate and distinct from the employer's assets and the employer's motivation and ability to pay.

The employer will show the account plus reinvested investment returns as an "other asset" on the balance sheet. It will show the accumulated deferred compensation obligation plus investment returns as a liability in a recognition transaction. The footnote disclosures in the financial statements' notes will also express the intention to use the proceeds from the financial instrument to fund the plan. The notes will state it is available to general creditors, which meets the code's strict interpretation of "funding" the plan.

The use of a tax-deferred annuity or life insurance policy to fund the plan softens one of the disadvantages of a funded plan. Any interest earned within the annuity or life insurance policy is tax deferred until the proceeds are withdrawn.

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1. Treas. Reg. §1.451-2
2. The name derives from Letter Ruling 8113107 (December 31, 1980), the first IRS letter ruling regarding such a trust, which was issued to a rabbi whose congregation had established a trust for him.

At that time, the interest income which has built up in the plan is taxable to the employer. However, this is offset because both the principal and interest of the plan are deductible to the employer as compensation paid.

> **Note.** Nonqualified deferred compensation amounts are taken into account for FUTA purposes. They are reported for FUTA at the **later** of when services are performed or when there is no substantial risk of forfeiture. They are earmarked with a code Y in box 12 of Form W-2 in order to not confuse the compensation with disqualifying social security earnings in postretirement years.

The rabbi trust arrangement exploded in the 1990s and early 2000s. There were numerous marketing ideas trumpeting the concepts such as supplemental executive retirement plan (SERP), private pension plans, and top-hat plans. The focus of the activity centered on:

1. Creating deferred compensation as a guaranteed investment, hopefully as far away from the corporate creditors as possible, including off-shore havens beyond the reach of U.S. judicial control.
2. Hastening the triggers to distribution so employees had a short reach to control timing of distribution, while avoiding current taxation. Examples of timing triggers included "hardship," "change in control," and "unforeseen emergency" distributions that could be used immediately to get funds out of plans. Other triggers, called "haircuts," allowed the timing to be immediately accelerated if the participant ceded a small amount back to the employer at any time.

All of this maneuvering was to move control away from the general creditors by getting assets in a judgment-proof location and getting effective timing to the participant at the participant's election and discretion. However, the plan had to maintain the asset's control and timing issues to remain tax-deferred.

In the early 2000s, creditors of major corporations found they could not collect against these accounts. Consequently, Congress enacted IRC §409A to govern the perceived tax and economic abuse of nonqualified plans. While the rules do not provide many obstacles to grandfathered plans[3] with the right intentions, material modifications to existing agreements can subject the plan to the new rules. All soundly constructed plans should be made by January 1, 2008, by following the final regulations issued April 10, 2007 (corrected July 31, 2007).[4]

> **Caution.** The penalty for failure to follow the act is severe. The participant in a plan determined not to comply with the act results in:
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> - Inclusion of the deferred amount in income of the participant,
> - A penalty at 1% above the underpayment rate, and
> - **A 20% excise tax**. The company would get an immediate tax deduction as salary for disqualified plans, mitigating some of the harshness of disqualification.

The new rules provide the following under the American Jobs Creation Act of 2004 and the final regulations:

- Deferral elections must be **made in the first 30 days** of initial employment.
- Deferral elections for continuing employees must be **made prior to December 31 of the year prior to the compensation period.** The election can be changed prior to December 31; however, whatever is binding on December 31 controls. Future year elections, sometimes called "evergreen" elections, are effective if allowed under local law.

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3. Generally, undisturbed plans in existence on September 17, 2003

4. Treas. Reg. §1.409A and Treas. Decision 9321, 2007-19 IRB 1123

- Compensation changes during the year must have **a deferral election within 30 days, 90 days, or six months in certain circumstances** such as for raises, commissions, employer stock, company value, and bonuses.
- Separation pay (severance pay) is **not considered a form of deferred compensation** if the employer is required to pay it in voluntary and involuntary terminations.
- Separation pay **does not apply to collectively bargained plans.** The IRS has said the regulations are **not intended** for the rank and file.
- **Short-term benefits (**$5,000 or less in two years following employment) are **not deferred compensation.**
- **Separation pay benefits** that are **less than twice the employee's annual salary** or the defined benefit plans meeting funding limitations of $225,000 ($220,000 in 2006) under §401(a)(17) are **not separation pay.**
- **Rabbi trusts** that restrict the payment to deferred compensation while excluding the reach of general creditors is **immediately taxable on insolvency and bankruptcy** if they are withdrawn to defeat creditors.
- **Foreign trusts** holding deferred compensation (under the Gulf Opportunity Zone Act) are **precluded from deferred taxation.**
- The separation provisions **do not apply to welfare benefit plans** such as certain **bona fide** sick pay, vacation leave, disability plans, or death benefit plans.
- **Short-term deferrals** paid within 2$^{1}/_{2}$ months following year-end do not apply to separation pay.

Example 2. Bob earned a bonus for 2007 when both his company's performance and his individual performance goals were met for the year. Bob receives his bonus by the 15th day of the third month following year end. The bonus is not deferred compensation.

Note. There are no expressed contribution limits to corporate NQDC plans, because theoretically the market forces contain abuses in the area between willing buyers (employers) and sellers (employees). Even the vigilant post-Enron Congress kept this provision alive. Only the unreasonable compensation rules and the $1 million deduction limit of §162(m) keeps the limits on NQDC plans in check.

Note. Some commentators believe that Congress is overreaching in trying to govern private compensation issues between private businesses and their employees

IRC §409A applies to amounts deferred after December 31, 2004. For deferral elections in 2006, the deferral election must have been made before December 31, 2005, and for deferral elections in 2007, the election must have been made by December 31, 2006.

IRC §457 TOP-HAT PLANS

A top-hat plan provides additional deferred compensation to a select group of management employees. One top-hat plan is the §457 plan. **This plan covers state and local governmental units and certain nonprofit organizations.** Unlike their counterparts in the commercial world, the entities providing the plans are tax exempt. Therefore, to curb unlimited deferral, plan ceilings or contribution limits apply.

The amount of income that may be deferred under a §457 plan changes annually. The contribution is limited to the lesser of the ceiling amount or 100% of the employee's compensation.[5]

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5. IRC §§457(b)(2), (c), (e)(15)

Year	Ceiling Amount	Catch-Up Contribution
2003	$12,000	$2,000
2004	13,000	3,000
2005	14,000	4,000
2006	15,000	5,000
2007	15,500	5,000
2008	15,500	5,000

The $15,000 ceiling amount is adjusted for inflation after 2006.

The **plan ceiling** applies to all amounts deferred under an eligible plan, whether by salary reduction or by nonelective employer contribution.[6] However, it applies only to amounts contributed under a §457 plan. Consequently, if an employee participates in both a §403(b) plan and an eligible §457 plan, the employee is not required to reduce the maximum deferral limit of the §457 plan by the amount of elective deferrals he makes to the §403(b) plan.

The §457 plan allows but does not require individuals who have attained age 50 to make additional catch-up contributions.

The $5,000 amount is also adjusted for inflation under §414(v).

Example 3. Frank, age 61, becomes eligible to participate in a plan in 2006. The plan provides a normal retirement age of 65. The plan allows deferrals up to the legal maximum. Frank's 2006 compensation is $40,000 and he wants to defer the maximum amount.

Because Frank is more than three years away from normal retirement age, he does not qualify for the special contribution rules. This limits Frank to the maximum annual contribution plus the maximum catch-up contribution. Frank may defer $20,000 ($15,000 + $5,000).

Special Rule

A higher amount may be deferred in each of the last three years **prior** to normal retirement age. The deferral is limited to the **lesser** of:

1. Twice the regular dollar amount of permitted deferrals, or
2. The normal limitation increased by the unused portion of the normal limitation from earlier years.[7]

The deferral amount may not exceed the compensation for the year.

Example 4. Using the same facts as **Example 3,** Frank elects to only defer $2,000, leaving $13,000 of underutilized limitation in 2006.

In 2007, Frank again earns $40,000. Because 2007 is one of the last three years before normal retirement age, Frank is able to use the special rule to compute his maximum deferral limit. His maximum deferral amount is determined as the **greater** of:

a. Normal rule: $15,500 + $5,000 = $20,500, or
b. Special rule: The **lesser** of:
   1. Twice the regular dollar amount: $15,500 × 2 = $31,000, or
   2. **Normal limit plus unused portion from earlier years: $15,500 + $13,000 = $28,500.**

6. Treas. Reg. §1.457-2(b)(1)
7. IRC §457(b)(3)

Example 5. Using the prior facts, assume we are in year 2010. This is the normal retirement year for the plan and Frank is age 65. If we assume Frank made no deferrals in any of the prior years, he is still limited to the basic annual limit plus the catch-up amount. If we assume the basic amount remained at $15,000 and the catch-up amount remained at $5,000, Frank's maximum deferral is $20,000. Frank does not qualify for the special "last three years before retirement" rule illustrated in **Example 4** because this is his normal retirement year.

Observation. The catch-up rule is not used in the last three years before retirement because the deferral limit for these years is usually higher than the catch-up amount allowed under IRC §414(v)(6)(c).

An individual who participates in a §457 plan is **not** treated as an active participant in a retirement plan for purposes of the rules on deducting contributions to an individual retirement account (IRA). Consequently, he can make **deductible contributions** to an IRA regardless of the amount of compensation received.[8]

Example 6. Danielle is age 42 and married. She works for the University of Illinois Medical School as a part-time surgical instructor and earns $35,000 in 2007. She also runs her own consulting practice, which provides malpractice testimony to plaintiff lawyers who sue in medical malpractice cases. She files Schedule C for that business and reports earnings of $40,000. The University provides a defined benefit plan through the State University Retirement System (SURS) and Danielle must contribute 8% to the plan in lieu of social security. Danielle's joint tax return reports adjusted gross income of $140,000.

Danielle contributes $15,500 in her university §457 retirement account and contributes $4,000 in a Roth IRA. She also contributes $14,500 into her university §403(b) annuity plan, which is tax sheltered.

Question 6A. What can she contribute to a 401(k) and profit-sharing pension plan that she established this year for her self-employed sole employee Schedule C business?

Answer 6A. The Roth IRA and the §457 do not require adjustments. The §457 plan does not require Danielle to be an active participant in a qualified plan. The §457 plan is similar to a nonqualified deferred compensation plan. The Roth IRA is allowed because she is married, has adjusted gross income less than the $156,000 – $166,000 phaseout range for 2007, and has qualified plan coverage.

The §403(b) plan is limited to a maximum 100% of compensation, or $15,500. Participation in a §403(b) elective-deferral plan is treated as if the participant, not the employer, made the §403(b) contribution.

Note. Taxpayers having both a §403(b) plan and a §401(k) plan must share the deferral limit of $15,500 for 2007.[9] However, §457 plans are not required to share deferral limits because the §457 participant is not considered an active participant in a retirement plan.

Finally, the plan limit for the profit-sharing plan is the lesser of $45,000 or 25% of earned income after the profit-sharing contribution. Earned income is defined as the income from self-employment, reduced by one-half of the self-employment tax. This is considered a limitation on employer limits.[10] However, IRC §415(c) does not require §457 plans to coordinate.

8. IRC §219(g)(5)

9. IRC §402(g)

10. IRC §415(c)

Because Danielle is self-employed, she must reduce her Schedule C income by the percentage of contribution to the profit-sharing plan. This is accomplished by dividing the desired contribution by one plus the desired contribution. Danielle wants to maximize the contribution, so she uses 20% (.25 ÷ (1.00 + .25)).

Note. If Danielle wanted to contribute 10%, the contribution percentage equivalent is 9.09% (.10 ÷ (1.00 + .10)).

The limitation and maximum contribution for Danielle (assuming a 25% profit-sharing contribution) are:

Plan	2007 Plan Ceiling Limit	Percent of Compensation Limit	Maximum Contribution for Danielle
§457	$15,500	100%	$15,500
§403(b)	15,500	100%	14,500
Roth IRA	4,000	0%	4,000
Profit sharing plan	45,000	20%	7,435
§401(k) elective deferral	15,500	100%	1,000
Total 2007 contributions			$42,435

Danielle's 401(k) elective deferral is limited to $1,000 due to the combined limit of $15,500 with her 403(b) plan.

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A §457 plan must provide that amounts will not be available to an employee prior to the earlier of the employee:

- Reaching age 70½,
- Being severed from employment with the employer, or
- Being faced with an unforeseeable emergency.[11]

The plan must also meet the minimum distribution requirements that apply to qualified plans under §72(t).[12]

Income reporting on a §457 distribution can be deferred by rolling the distribution into another §457 plan maintained by a governmental entity, an IRA, a qualified plan, or a §403(b) tax-sheltered annuity.[13] Similarly, §457 plans can accept rollovers from these other plans if they separately account for the rolled-over amounts.[14]

Amounts deferred under a §457 plan are not subject to income tax withholding and are not included in box 1, Form W-2. However, they are reported on the participant's W-2 in box 12 using code G.

Taxable distributions are included in income as wages, subject to income tax withholding, and are reported on the participant's Form W-2, not on Form 1099-R. However, if the deferrals were properly taken into account when they were contributed (or when they vested, if later), the distributions are not subject to employment tax because they were already taxed.

11. IRC §457(d)(1)

12. IRC §457(d)(2)

13. IRC §457(e)(16)

14. IRC §§402(c)(8) and (10)

Generally, the rules of §457 are very similar to the rules of nonqualified deferred compensation. The exception is that there are limitations to §457 plan contributions, whereas for nonqualified deferred compensation there are none. Generally, §457 plans have more lenient qualifications than §409A nonqualified plans. However, §457 plans that lose qualification status as an employer or participant[15] become governed under §409A plans and are subject to the harsh 20% excise tax provision. IRC §457(f) plans are nonqualified deferred compensation plans established by tax-exempt organizations.

GOVERNMENT PLANS

In addition to §457 plans, many other federal, state, and local pension plans exist. These plans are unique in that they are exempt from ERISA, similar to many church plans.[16] This ERISA exemption leads to interesting differences in plan operations.

Example 7. Wayne is a firefighter injured in the line of duty. He applies for and receives lifetime permanent total disability benefits. Wayne is covered by a municipal defined benefit plan authorized by the state legislature. Under the plan, Wayne's normal retirement age is age 60. Wayne is currently 40 years old. Wayne's disability is paid from the municipal defined benefit plan and is not taxable to him. This is the case because the disability pension is paid to him in lieu of his right to claim workers' compensation under the state workers' compensation plan.

Example 8. Martha is a member of the State University Retirement Fund. Her husband, Tom, is a police officer. They are the same age and expect the same retirement incomes. They are planning to divorce. Tom's plan is exempt from ERISA, and **does not** provide a surviving spouse benefit. Martha's plan does. Therefore, Martha's plan has a significant advantage over Tom's. If these plans are split equally in the QDRO, Martha will cease to get benefits from Tom's plan at his death. However, Tom would continue to get benefits from Martha's plan at her death. This difference should be addressed at the time the marital assets are split.

Note. Qualified domestic relations orders (QDROs) are explained later in the chapter under "Special Retirement Planning Issues."

Federal Government Plans

Federal government plans consist of the federal employees retirement plan (FERS), the civil service retirement system (CSRS), and the thrift savings plan (TSP) administered by the Office of Personnel Management (OPM).

The **FERS plan** has the following features:

- FERS began January 1, 1987. Almost all U.S. government employees hired after December 31, 1986, are automatically covered by the plan. FERS was designed to eliminate overlapping pension systems by integrating with other federal plans such as CSRS and social security. It was designed to address double and triple dipping by coordinating benefits between these plans to provide a single unified benefit.
- Employees pay full social security taxes plus a small contribution to the basic benefit plan. Essentially, the employee contributes 0.8% to the basic benefit plan and 6.2% to social security. The integration and coordination of benefits with social security allows the plan to provide richer benefits to some participants and limit excesses in other components of the federal plans.
- The FERS plan provides for an early retirement benefit at age 50, with only 20 years of service. This follows the same plan as the generous CSRS, which it will eventually replace.

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15. IRC §457(f)

16. Church plans are exempt under the separation of church and state rules.

The **CSRS** is still maintained for those employees who were grandfathered into it, as well as those who did not elect to transfer balances to the FERS plan. CSRS also instituted a social security offset for service after January 1, 2003, to make the plan comparable to the FERS system. This social security offset lowers the CSRS amount paid to retirees once they reach normal social security retirement age. Since the CSRS is a qualified plan, participants use the Simplified Method (explained later in this chapter) to determine any tax-free recovery of employer contributions that previously were taxable at the time of contribution.

The OPM also offers the **thrift savings plan** (TSP) that is similar to the defined contribution §401(k) plan offered in the private sector. The TSP provides for the following contributions to the account-based plan:

- Employees may make 100% elective deferrals up to the IRS limit of $15,500 in 2007. There is a catch-up provision of $5,000 for 2006 and 2007.
- The U.S. government agency matches dollar-for-dollar the first 3% of an employee's elective deferral (3% gets matched by 3%).
- The U.S. government agency also matches $0.50 per dollar on the next 2% of employee's elective deferral (7% gets matched by 3.5%).
- The U.S. government makes a 1% contribution of salary, regardless of the employee's participation in the plan.

RAILROAD RETIREMENT

President Franklin D. Roosevelt approved a Railroad Retirement Act on June 27, 1934. The Railroad Retirement Board governs the tier I and tier II railroad retirement benefits. In 1974, pension reform unified and created a coordination of tier I benefits. Those changes mirrored the benefit structure of the tier I portion of the plan and set up coordinated earnings credits, benefit payment levels, and taxes on tier I railroad benefits with social security. Social security insures the tier I benefit by making the two systems substantially equivalent. The amount of tier I retirement income is reported on Form RRB-1099, *Payments by the Railroad Retirement Board*, and is very similar to Form 1099-SSA.[17]

Tier II benefits are nonsocial security equivalent benefits and are taxable like government annuity plans. While the proceeds are not funded with commercial annuities, the plan involves an investment in a contract that pays an actuarial benefit that is "annuitized" or paid out over the joint life of the participant and spouse. The green Form RRB-1099-R is used to report the tax consequence of the tier II benefits.

PAYER'S NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092 PAYER'S FEDERAL IDENTIFYING NO. 36-3314600	**2006** 3. Employee Contributions		**ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD**	
1. Claim Number and Payee Code	4. Contributory Amount Paid		**COPY B -** **REPORT THIS INCOME ON YOUR FEDERAL TAX RETURN. IF THIS FORM SHOWS FEDERAL INCOME TAX WITHHELD IN BOX 9 ATTACH THIS COPY TO YOUR RETURN.** **THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.**	
2. Recipient's Identification Number	5. Vested Dual Benefit			
Recipient's Name, Street Address, City, State, and Zip Code	6. Supplemental Annuity			
	7. Total Gross Paid			
	8. Repayments			
	9. Federal Income Tax Withheld			
	10. Rate of Tax		11. Country	12. Medicare Premium Total

FORM RRB-1099-R

The General Rule (explained later in this chapter) is used to compute the taxable income from the tier II retirement benefits, since there is an investment in the contract.

17. Similar to state and local plans, the Form RRB-1099-R has an offset for workers' compensation that provides for nontaxable disability income in lieu of taxable railroad retirement disability income.

INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs)

Tax practitioners are becoming very familiar with individual retirement arrangements (IRAs). Congress originally envisioned the IRA as a means of allowing individual taxpayers with no other retirement plan to save tax-deferred dollars for their retirement. Taxpayers now realize the importance of the IRA in establishing the family bank. While IRAs were authorized in 1978, they increased in popularity once taxpayers could roll over distributions from qualified plans. The allowance of self-directed IRAs has also increased the popularity of the IRA. Self-directed IRAs allow retirement funds to be used for real estate investments, timberland, mortgages, and other investments provided certain rules are followed.

ELIGIBILITY

A taxpayer must have earned income to be eligible for an IRA. The taxpayer may contribute to several types of plans, including the traditional IRA, nondeductible IRA, and Roth IRA. There are 12 different types of IRA accounts, including inherited, educational, SIMPLE, Roth, inherited Roth, and so on. Congress created the earned income requirement to prevent passive investors from recycling investment income into tax-deferred vehicles.

Income Limitations

The deduction for traditional IRAs have an income limit and phaseout provision for certain high-income taxpayers who are considered active participants in an employer retirement plan.[18] If the deduction is completely phased out, a nondeductible IRA contribution or a Roth IRA is possible. There are special modified adjusted gross income (MAGI) phaseouts for these individuals. The phaseout ranges are:

2007 Traditional IRA MAGI Phaseouts

Filing Status	Phaseout Range
Single or head of household	$52,000 to $62,000
Married filing separately	0 to 10,000
Married filing jointly (both covered)	83,000 to 103,000
Married filing jointly (one covered)	156,000 to 166,000

The MAGI adds back various exclusions to adjusted gross income (AGI). Exclusions include social security and railroad retirement benefits.

The following is the IRA contribution worksheet from 2006.[19]

18. IRC §219(c)

19. IRS Pub. 590, *Individual Retirement Arrangements*, page 19

Worksheet 1-2. **Figuring Your Reduced IRA Deduction for 2007**
(Use only if you or your spouse is covered by an employer plan and your modified AGI falls between the two amounts shown below for your coverage situation and filing status.)
Note. If you were married and both you and your spouse contributed to IRAs, figure your deduction and your spouse's deduction separately.
Certain employer bankruptcies. See *Catch-up contributions in certain employer bankruptcies* earlier, for information and instructions on how to complete lines 4 and 6 of this worksheet.

IF you ...	**AND your filing status is ...**	**AND your modified AGI is over ...**	**THEN enter on line 1 below ...**
are **covered** by an employer plan	single or head of household	$52,000	$62,000
	married filing jointly or qualifying widow(er)	$83,000	$103,000
	married filing separately	$0	$10,000
are **not covered** by an employer plan, but your spouse is **covered**	married filing jointly	$156,000	$166,000
	married filing separately	$0	$10,000

1. Enter applicable amount from table above . . . . 1. ________

2. Enter your ***modified AGI*** (that of both spouses, if married filing jointly) . . . . 2. ________

   Note. If line 2 is equal to or more than the amount on line 1, **stop here.** Your IRA contributions are not deductible. See *Nondeductible Contributions.*

3. Subtract line 2 from line 1. **If line 3 is $10,000 or more ($20,000 or more if married filing jointly or qualifying widow(er) and you are covered by an employer plan), stop here.** You can take a full IRA deduction for contributions of up to $4,000 ($5,000 if you are age 50 or older) or 100% of your (and if married filing jointly, your spouse's) compensation, whichever is less . . . . 3. ________

4. Multiply line 3 by 40% (.40) (by 50% (.50) if you are age 50 or older). If married filing jointly or qualifying widow(er) and you are covered by an employer plan, multiply line 3 by 20% (.20) (by 25% (.25) if you are age 50 or older). If the result is not a multiple of $10, round it to the next highest multiple of $10. (For example, $611.40 is rounded to $620.) However, if the result is less than $200, enter $200 . . . . 4. ________

5. Enter your compensation minus any deductions on Form 1040, line 27 (one-half of self-employment tax) and line 28 (self-employed SEP, SIMPLE, and qualified plans); or on Form 1040NR, line 27 (self-employed SEP, SIMPLE, and qualified plans). If you are filing a joint return and your compensation is less than your spouse's, include your spouse's compensation reduced by his or her traditional IRA and Roth IRA contributions for this year. If you file Form 1040 or Form 1040NR, do not reduce your compensation by any losses from self-employment . . . . 5. ________

6. Enter contributions made, or to be made, to your IRA for 2007 but **do not** enter more than $4,000 ($5,000 if you are age 50 or older). If contributions are more than $4,000 ($5,000 if you are age 50 or older), see *Excess Contributions,* later. . . . . 6. ________

7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040, 1040A, or 1040NR line for your IRA, whichever applies. If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8 . . . . 7. ________

8. **Nondeductible contribution.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606 . . . . 8. ________

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Roth IRAs have a similar requirement for earned income and a separate contribution phaseout rule based on MAGI:

2007 Roth IRA MAGI Phaseouts

Filing Status	Phaseout Range
Single or head of household	$99,000 to $114,000
Married filing separately	0 to 10,000
Married filing jointly	156,000 to 166,000

Roth MAGI computations are the same as regular IRA calculations except they exclude the conversion of traditional IRAs to Roth IRAs.

The 2006 worksheet to determine the amount of a Roth IRA contribution is shown below.[20]

1.	Enter your modified AGI for Roth IRA purposes	**1.**	________
2.	Enter: • $150,000 if filing a joint return or qualifying widow(er) • $-0- if married filing a separate return and you lived with your spouse at any time in 2006 • $95,000 for all others	**2.**	________
3.	Subtract line 2 from line 1	**3.**	________
4.	Enter: • $10,000 if filing a joint return or qualifying widow(er) or married filing a separate return and you lived with your spouse at any time during the year • $15,000 for all others	**4.**	________
5.	Divide line 3 by line 4 and enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000	**5.**	________
6.	Enter the lesser of: • $4,000 ($5,000 if you are age 50 or older), or • Your taxable compensation . . .	**6.**	________
7.	Multiply line 5 by line 6	**7.**	________
8.	Subtract line 7 from line 6. Round the result up to the nearest $10. If the result is less than $200, enter $200	**8.**	________
9.	Enter contributions for the year to other IRAs	**9.**	________
10.	Subtract line 9 from line 6	**10.**	________
11.	Enter the lesser of line 8 or line 10. This is your **reduced Roth IRA contribution limit**	**11.**	________

20. IRS Pub. 590, *Individual Retirement Arrangements*, page 61

Contribution Limits

The contribution limit to traditional and Roth IRAs is a combined limit. The total contribution is $4,000 plus a catch-up contribution of $1,000 for those at least age 50 by the end of the 2007 tax year. All IRA contributions combined cannot exceed $4,000 or $5,000 for those age 50 or older. For 2008, the total contribution is $5,000 plus a catch-up of $1,000.

Nondeductible contributions to an IRA are still available. Nondeductible contributions are limited to the same $4,000 and $1,000 catch-up, less the amount deducted in a traditional IRA. The main advantage is that the nondeductible contributions grow tax-deferred.

QUALIFIED SMALL BUSINESS PLANS

One difference between a qualified plan and a nonqualified plan is that qualified plan contributions are made to a tax-exempt trust, which makes the investment returns nontaxable. In addition, a qualified plan provides a tax deduction to the employer when the plan is funded, as opposed to when the participant receives a plan distribution. This provides a fundamental advantage to the qualified plan. In a nonqualified deferred compensation plan, the employer may set aside the funds; however, because a participant does not have a right to the funds due to their availability to general creditors, the employer **cannot deduct** the funding. Furthermore, the investment income in the arrangement is taxable. This is the case because it is not held in a tax-exempt trust, but instead may be held in a tax-deferred life or variable annuity product.

The operation of a qualified plan is significantly more complex. While both qualified and nonqualified plans are subject to ERISA requirements, qualified plans have additional rules from an income tax viewpoint. If a **qualified plan** is found to be **nonqualified:**

1. The plan **loses its exempt status,** and is taxed at the trust income tax rates. Trust income tax rates are the most progressive rates in the code, reaching the 35% bracket at $10,450.
2. The plan **balances become taxable** to the participant at his applicable tax bracket.
3. **Penalties for underpayment of taxes** are also assessed against the plan trustees for failure to timely deposit payroll taxes.

Because of the severe consequences of a simple error in administrating and operating a plan, most plans use a qualified third party administrator to assist and consult in the operation and administration of the plan. This complexity creates additional expense. Congress responded to these problems by creating **small business plans** that are relatively easy to operate and administer. While these plans are simple to administer, they have very little latitude in coverage. They also have very few features favorable to the employer funding the plan such as coverage, vesting, required match, and social security taxed contributions.

SEP-IRA

Qualified defined contribution plans can limit contributions for participants who work less than 1,000 hours; however, small business plans generally provide coverage for all employees. Simplified employee pension–individual retirement arrangements (SEP-IRAs) provide that any eligible employee who earns more than $500 in 2007 will receive a contribution. For seasonal workers in farming or retail operations, this simple provision can require the establishment of several accounts with small balances to carry, fund, and account for each year. SEP-IRA participants are immediately vested. Account balances are maintained until the employee reaches normal retirement age. If 60% of the plan balance relates to key employees, a 3% required contribution **must** be made based on the income of each participant.

Both small business plans and qualified plans include the owner as a participant, even though in partnerships and proprietorships they do not receive W-2 compensation. Small business plans have a formula to determine the percentage funding (contribution rate ÷ (1 + contribution rate)), and determine earned income by reducing self-employment income by one-half of the self-employment tax.

The contribution limit is illustrated in the following example.

Example 9. Monique operates a nail salon as a sole proprietorship. In 2007, she has net Schedule C self-employment income of $70,000. She may contribute up to $13,011 in her SEP or qualified plan.

SEP and Qualified Plans Worksheet

		Taxpayer
A.	Plan contribution rate	0.250000
B.	Rate in line 1 plus one	1.250000
C.	Self-employed rate as a decimal (divide line 1 by line 2)	0.200000
1.	Net profit from self-employment	$70,000
2.	One-half of self-employment tax	$4,946
3.	Subtract line 2 from line 1	$65,054
4.	Self-employed rate as a decimal	0.200000
5.	Multiply line 3 by line 4	$13,011
6.	Multiply $225,000 by your plan contribution rate	$56,250
7.	Enter the smaller of line 5 or line 6	$13,011
8.	Contribution dollar limit	$45,000

SEP-IRAs are available to small businesses by simply completing IRS Form 5305-SEP. The form is not filed with the IRS. It is kept with the plan information in the event of an examination. The SEP-IRA cannot be adopted by employers with other qualified pension plans, except those who only have collectively bargained plans. The limit on the contributions to the SEP-IRA plan is the lesser of 25% of compensation or $45,000. Employees may also make a $4,000 employee contribution and a $1,000 catch-up contribution beyond the employer's contribution to the SEP-IRA. As with traditional IRAs, the employee elective contribution is deducted on the employee's Form 1040 and is subject to the gross income, filing status, and plan participation rules. The employer contributions for employees who are not owners are exempt from FICA tax, and the elective deferrals are subject to FICA. Owner/employee contributions, whether elective deferral or employer-provided, are not deductible in computing self-employment taxes.

SARSEP

A salary reduction simplified employee pension (SARSEP) allows participants to make employee elective deferrals in plan years established prior to 1997. In 1997, the SARSEP plan was replaced by the SIMPLE plan. For previously adopted SARSEP plans, contributions are still allowed. The limits on the 2007 employee elective deferral are the same as the §401(k) limitation of $15,500. The contribution reduces the taxable wages reported on the employee's Form W-2. Employees may also make a $4,000 employee contribution and a $1,000 catch-up contribution beyond the employer's contribution to the SEP-IRA. As with traditional IRAs, the employee contribution is deducted on the employee's Form 1040 and is subject to the gross income, filing status, and plan participation rules. SEP plans are also available to self-employed individuals. The tax deduction is taken on the taxpayer's Form 1040; however, it is not a deduction in computing self-employment tax for employer contributions or elective deferrals.

SIMPLE IRA

To establish a SIMPLE plan, the taxpayer must complete Form 5304-SIMPLE or Form 5305-SIMPLE. Form 5304 is used when the **employee chooses** the financial institution(s) that will manage the contributions. Form 5305 is used when the **employer chooses** the financial institution. The savings incentive match plan for employees (SIMPLE) is similar to the SEP; however, it has some superior features:

1. The earnings requirement threshold is $5,000 for 2007, as opposed to $500 for the SEP. This is an improvement in administering and funding the plan.
2. The SIMPLE does not require top-heavy testing to determine if key employees' balances are 60% of plan balances. This advantage is somewhat overstated because the SIMPLE requires a safe-harbor matching by the employer, in that it presupposes the plan is top-heavy. In other plans, the safe-harbor match is tested for being top heavy, and if so, a safe-harbor match is then made. This is an example of "simple" being "simply" more expensive. Proper plan design and study can determine if the simplification is affordable.
3. Employees can fund their SIMPLE through elective deferrals.
4. The SIMPLE employer is required to contribute:
   - A 3% **match** of compensation (adjustable down to 1% in two of the five years, as a guard against unfavorable business conditions), or
   - A 2% nonelective (across the board) contribution for each employee who earns more than $5,000.

Example 10. Julie and Ted are working for the same employer, and both make $50,000 per year. Julie elects to defer $1,000 to a SIMPLE account, and Ted elects to take the money as salary. The employer elects the 3% match feature in funding the plan for each employee who makes more than $5,000. Julie has a total of $2,000 in her account ($1,000 she contributed and $1,000 her employer matched). Ted receives no employer contribution to his account.

Note. The 3% matching is a dollar-for-dollar match. Had Julie elected to defer more than $1,500, the company would have paid up to 3% of compensation, but not in excess of $1,500.

Example 11. Use the same facts as **Example 10,** except the employer elects to make a 2% nonelective contribution to each employee who makes more than $5,000 for the year. Regardless of whether they put in an elective contribution or not, both Julie and Ted get $1,000 contributed to their SIMPLE IRAs.

Observation. Plan participation in match programs traditionally averaged 75% in the last five years. The deferral rate of employee elective contributions was 5% regardless of the extent of the match.[21] This informational demographic can be used to determine the expected cost of employer contributions to the adopted plan and to avoid top-heavy traps in lieu of using a SIMPLE account.

Elective deferral limits on SIMPLE plans are not identical to other qualified plans, such as SARSEP, §401(k), §403(b), and other §457 plans.[22] SIMPLE plans have a contribution limit based on 100% of compensation, like other plans. However, this is limited to a maximum of $10,500 in 2007. Catch-up contributions of $2,500 are allowed for participants 50 years and older.

21. Robert G. Wuelfing, *Marketplace Outlook*, 2005 Marketplace Update from the DOL/EBSA website of the SPARK Institute response to the 2006 National Summit on Retirement Saving. See www.dol.gov/ebsa/pdf/Wuelfing070505.pdf.

22. All of these plans have §402(g) limits of $15,500 for 2007, and SARSEP can make a $1,000 catch-up contribution.

§412(i) PLANS

Life insurance and annuities were historically marketed as de facto retirement products prior to the proliferation of the mutual fund industry in the 1970s. Funds invested in a life insurance policy or an annuity grow tax-deferred **outside** a qualified retirement trust. This shelters the investment gains from taxation. Combined with a qualified retirement trust, the premiums (principal) to fund the life insurance can be tax deductible. A defined benefit plan is a qualified employer-sponsored retirement plan that provides the employee with a specific retirement benefit amount. The benefit is determined according to a formula

IRC §412(i) plans are considered hybrid defined benefit plans because life annuities and life insurance premiums are used, the premiums (contributions) are tax deductible, and growth is tax deferred. While the §412(i) plan may look like an account balance plan, the life annuity gives it the defined benefit feature and the life insurance portion can be used by future generations in estate planning.

A §412(i) plan must comply with IRC §412(i). If it complies, it is exempt from the complex funding rules for other plans included in §412. These plans typically have three features:

1. The plan is funded solely with individual or group life insurance and/or annuity contracts that are part of the same series and use the same mortality tables and rates for all participants. Conservative §412(i) plans tend to consist of no more than 50% life insurance and no less than 50% annuity. Some plans may go as high as 67% insurance and 33% annuity.

Caution. Plans having more than 67% life insurance are overly aggressive and should be avoided.

2. The insurance contracts must fund benefits using level premiums. When a participant enters the plan, payments may not extend later than the retirement date stated in the plan.

3. Only the insurance contracts can provide the plan benefits and an insurance company must guarantee these contracts.

IRC §412(i) plans can be established late in the tax year, provide full tax benefits for the entire year, and do not require quarterly contribution deposits like defined benefit plans. However, §412(i) plans must be formed prior to year-end rather than by the due date of the tax return, as allowed with some qualified plans.

These plans work well for small businesses and self-employed individuals. When properly structured, they also protect the family and heirs by including an insured death benefit, which further reduces taxable income and increases tax deductions.

Advantages

- The maximum current **tax deductible contributions** for the business are **slightly higher than the amount of contribution necessary to fund a $225,000 benefit** (the limit of defined benefit plans) because of morbidity.
- There can be no over-funding or under-funding of the plans because contributions are **based solely on the guarantee provision of the level premium life and annuity contracts.**
- There is **no full-funding limitation** under ERISA, IRC §404(a)(1)(A), **or a current liability test** to limit contributions. No actuarial certification is required.
- Unlike traditional defined-benefit plans, **no quarterly contributions are required,** and the plan may be funded annually without interest.
- Typically, the **IRS will not challenge the plan assumptions** since it is the contract guarantees that govern the required contributions. This permits higher deductions.

Disadvantages

- Because of the large required contributions, these plans **only work when the business is established and highly profitable.** It usually works best when the business owner is within 10 years of retirement, is older than most of the firm's employees, and there are relatively few employees.
- The plan should **not make policy loans** or be used as a private bank because the IRS may attempt to impose the §4975 loan rule provisions. In addition, no lapsing of the contracts should occur (starvation of the corpus).
- There is **no flexibility in investments** because the plan is funded entirely with insurance contracts. This does not allow asset allocation and risk reduction. The plan is generally subject to higher fees and commissions.
- There may be **limitations to the deductions** or the amount of insurance that is purchased. There may be an income component (PS 58 cost) that is recaptured by the business owner.

The IRS has announced it will not be gentle when examining plans they believe to be abusive.[23] As a professional involved with management and the plan, the tax practitioner may have some exposure in these situations.

> **Observation.** When in doubt, taxpayers should deal only with reputable insurance companies and require their officers to certify the expected results.

There are three signals that a §412(i) plan may be abusive:

1. The company sells a life insurance contract to a highly compensated employee at surrender value, which is much less than FMV. Since the insurance company sets the contract values and there is no benchmark or publicly-traded market to determine the cash surrender value, favorable valuation may result when the policies are withdrawn.
2. The plan provides for favorable conversion privileges to variable universal life insurance and low surrender charges on life insurance face amount immediate reductions (increasing their underlying values). These tactics are designed to turn the policies into a modified endowment contract (giving them longer lives to defer taxes), with low insurance charges (preserving capital) and high returns (from shifting values) on tax sheltered investments. It could allow manipulation of timing and taxation without a corresponding benchmark.
3. The marketing material predetermines a plan termination or the tax deductible contributions for a company are front-loaded immediately prior to the final years of the owner's service. Then, the plan is scheduled for termination immediately after the retirement of the owner. This violates the permanency provisions of establishing and maintaining a plan under the code. It is a scheme to withdraw company deductible payments without including income for the major shareholders. No real pension protections and benefits were contemplated for the remaining employees in this scheme.

[23] IR 2004-21 (February 13, 2004), contains an excellent description of abusive plans and the regulations and revenue ruling on the cash-out feature of plans. Some plans have been added to the abusive shelter list maintained by the IRS.

SOLO-401(k) PLANS

The solo-401(k) first appeared in 2001. It is also known as the "solo k," the "individual §401(k)," or the "uni-k." The rules are similar to traditional §401(k) plans offered by large companies and SEP-IRAs designed for the self-employed. The solo-401(k) is adopted using a prototype document the taxpayer purchases, rather than a prototype safe-harbor form such as those used to establish a SEP-IRA (5305-SEP) or a SIMPLE (5304-SIMPLE). Once the account value exceeds $250,000, a Form 5500, *Annual Return/Report of Employee Benefit Plan*, must be filed with the Department of Labor. This is a compliance requirement that SEPs and SIMPLE plans do not have.

A Roth 401(k) feature can be incorporated into a solo-401(k) plan, allowing an initial selection of a tax-deductible/tax-deferred contribution or a nontax-deductible/nontaxable contribution. This feature provides personal retirement savings when a sole owner is not in a high tax bracket, and a tax deduction in the years the sole owner is in higher tax brackets.

Both the taxpayer and spouse are eligible for participation in a solo-401(k) plan. Therefore, contribution limits may double if the spouse is employed in the business.

The solo-401(k) has elective deferral limitations of $15,500, plus 25% of earned income to a maximum of $45,000, plus the catch-up provision of $5,000 for participants age 50 or older.[24] Assuming both spouses have earned income of $20,500 and are therefore limited by the 100%-of-compensation rule, and both are over age 50, a combined limitation of $41,000 in elective deferrals is possible. Elective deferrals are subject to self-employment taxes.

The solo-401(k) also has the §415(c) employer limitation. This is the lesser of 25% of earned income or $45,000 for both owner and spouse. The employer contribution feature adds to the value.

Solo-401(k) Compared to Other Plans

The solo-401(k) allows a maximum contribution of 100% of earned income; however, the SEP-IRA only allows a 25% contribution. The maximum contribution for the SEP-IRA is $45,000, and the solo-401(k) has a $15,500 limit. The SIMPLE limitation on elective deferrals is $10,500, with a catch-up of $2,500, compared to $15,500 and a catch-up of $5,000 for the solo-401(k). This comparison clearly demonstrates the larger contributions available with a solo-401(k).

Note. The ability to choose the deductible contribution or the nondeductible/tax-exempt Roth contribution leads to a clear advantage over SEP-IRA and SIMPLE plans. The only downside of the solo-401(k) is the document cost and the Form 5500 filing requirement for plans over $250,000.

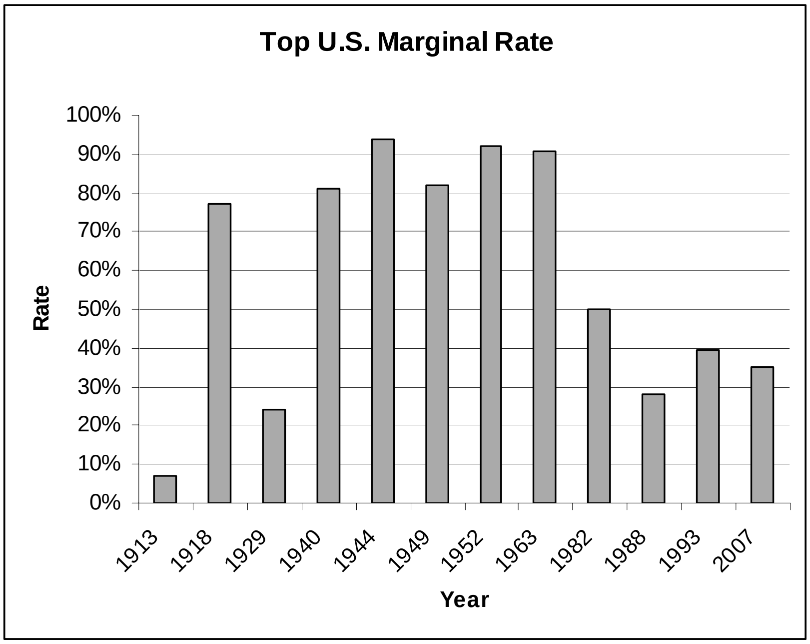
ROTH 401(k) PLANS

The Roth 401(k) was created by Congress in 2001, but employers could not begin offering them until 2006. Employers were hesitant to incorporate the Roth feature in their traditional 401(k) plans for various reasons:

1. Roth 401(k) plans were not made permanent when first introduced.
2. The employer is required to keep the Roth account balance separate from the traditional 401(k) balance.

Employees who are offered the opportunity to participate in a Roth 401(k) have a difficult decision to make. Are they better off with a traditional 401(k) contribution, which allows them to defer tax on both the contributions and earnings? Should they choose a Roth 401(k), providing no tax deduction, but allowing tax-exempt earnings and distributions? Their decision should be based on whether they believe their tax rate will be lower at the time of retirement than when they are making their contributions. The following chart shows the history of the top marginal U.S. tax rates since 1913.

24. IRC §402(c)(g)



The source of funds used to fund the Roth 401(k) further complicates the income tax issue. If the source is elective deferrals, the hurdle rate gets higher due to the fact that FICA must be paid on the income earned to fund the contribution. This mitigates the absence of tax on the withdrawal of contributions and investment income.

One significant difference between a Roth 401(k) and a Roth IRA is that the Roth 401(k) requires minimum distributions, whereas a Roth IRA does not. Generally, the required minimum distribution (RMD) table must be followed.

MONEY PURCHASE PLANS

Money purchase plans require a fixed percentage for annual contributions. Prior to retirement plan reform, these plans were able to provide 25% employer funding based on compensation, compared to the previously allowed profit-sharing limit of 15%.

Since reform, profit-sharing accounts allow the same limits as money-purchase plans, but not the disadvantage of the required annual contributions. **Failure to make a required money purchase plan contribution is subject to an excise tax.** As a result, there are fewer money purchase plans in existence today. These problems are easily avoided with discretionary profit-sharing plans. Generally, once started, money purchase plans must be funded annually.

The §402(g) elective deferral is 100% of compensation up to $15,500, with a catch-up of $5,000 for participants aged 50 years and older. The 25% of compensation under §415(c) is $45,000 for 2007.

TARGET BENEFIT PLANS

A **target benefit plan** is a hybrid of a defined benefit plan and a money purchase pension plan. It is similar to a defined benefit plan in that the annual contribution is based on the amount required to fund a projected retirement benefit when the participant reaches retirement age. The employer's initial contribution for the same group of employees may be identical whether a target benefit plan or a defined benefit plan is chosen. However, the target formula and the benefit formula must be the same and based on identical actuarial assumptions such as interest rates, mortality, and employee turnover.

In a **defined benefit plan,** if the actual experience of the plan differs from the actuarial assumption (for example, if the investment return is higher or lower than the assumptions), the employer either increases or decreases its future contributions to the extent necessary to provide the promised benefits. In a **target benefit plan,** the contribution, once made, is allocated to separate accounts maintained for each participant. If earnings of the fund differ from those assumed, this does not result in any increase or decrease in employer contributions. Instead, it increases or decreases the benefits payable to the participant.

In this regard, the target benefit plan operates like a money purchase pension plan. In a **target benefit plan,** contributions are determined as if the plan provides a fixed benefit. In a **money purchase pension plan,** contributions for identically compensated employees are the same even if their ages differ. In a target benefit plan, age is one of the factors that determine the amount of the contribution. Because older employees are closer to retirement, they have less time in which to have their benefits funded. Therefore, employer contributions on their behalf are greater, as a percentage of compensation, than for younger employees. Consequently, target benefit plans appeal to employers that desire to benefit older employees and that have a great proportion of younger participants.

Often, targeted benefit plans will consider the benefits of the employer-provided social security contribution in a funding method called **social security integration.** Essentially, lower compensated employees derive a larger benefit from social security than higher compensated employees because of the contribution and benefit cap on social security. This **integration** leads to **permitted disparity** in contributions because the contributions to the plan must be higher for the highly compensated in order for the benefits (after consideration of social security) to be identical to the lower compensated employees.

Target benefit plans require actuarial testing and rigorous monitoring to maintain plan compliance. Failure to maintain plan compliance can result in the trust being taxed at trust income tax rates, the imposition of an excise tax penalty, and taxability of the account balance to the participant. Professional fees to administer these plans are higher because of the risks of loss.

DEFINED BENEFIT PLANS

Sole-proprietors, partnerships, corporations, and exempt organizations can establish plans designed to provide a specific benefit at retirement. The coverage of employees of the business and employees of the owners' related businesses is a common problem. These plans require a disproportionate amount of plan contributions to the nonowners and less benefit to the single owner, unless there is an age disparity in the demographics of the employer. When there are few employees and the lower wage earners are substantially younger than the professional employees, the defined benefit plan works very well.

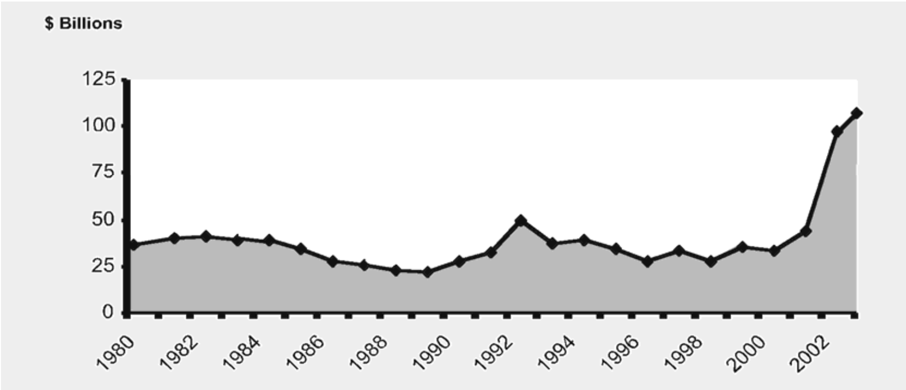
Unlike the target benefit plan, any deficiency in the plan funding must be made up by the employer, or the plan trustee is subject to a fiduciary liability to make the plan whole. In essence, the Department of Labor has enforced a 2-part rule in dealing with this issue:

1. If the plan's asset allocation model leads to higher investment returns, those returns are the exclusive benefit of the participants.
2. If the plan has a funding shortfall, the funding shortfall must be made up by the plan sponsor (employer), or by the fiduciary of the plan (usually top management).

This philosophy contributed more to the demise of the defined benefit plan than any other factor. Less than 38% of the 2003 U.S. retirees with pension coverage are expected to draw defined benefit pensions. This is down from 80% in 1981.[25]

The crisis is created by five years of poor investment performance in the post-2001 markets, the increasing age of the baby boomers, and the requirements that plan sponsors uphold their pension promises. The chart below shows the funding required to overcome the investment performance, and participant demographics of defined benefit plans. More recent data is not available, but it does not appear the trend is changing.

Funding Requirements for Defined Benefit Plans: 1980–2003[26]



The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) both prepared proposals to require private and publicly-traded companies to annually disclose the mark-to-market investment and actuarial results of pension performance. If the FASB and the IASB proposals become generally accepted accounting principles, companies can no longer actuarially smooth pension costs. Companies, seeking to avoid volatility, will continue to abandon defined benefit pension obligations, either through plan terminations or bankruptcy protection.

Clients who have neglected retirement funding in favor of building businesses and creating value in their companies are stepping into the most profitable 10 years in history. Deflecting earnings into defined pension plans (after meeting the standards of the defined contribution limitations) can save 40% for most owners, but not without careful planning.

> **Note.** On April 10, 2007, final regulations were issued for §415(e) which allowed multiple use bases on plan contributions. The significant changes are the repeal of the §415(e) combined limit on participation in both defined contribution and defined benefit plans of a single employer.

For example, defined benefit plan funding is limited to actuarially providing an annual benefit of $225,000. However, in order to achieve this level of compensation base, payroll taxes have to be incurred by C corporation owners, partners in partnerships and sole-proprietors. Since owners are essentially both the employee and the employer, this cost can substantially reduce the amount of the income tax deferral. This is especially true in the case of S corporations who meet the reasonable salary threshold and currently distribute earnings without incurring payroll taxes.

25. U.S. Department of Labor, Form 5500 data (2004) and from raw universe 5500 data files, as presented in "The State of Private Pensions: Current 5500 Data," Center for Retirement Research at Boston College, February 2006.

26. Ibid

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Therefore, planning requires funding of both the elective deferral in a §401(k) plan, a profit sharing plan, and a defined benefit arrangement, so that social security taxes are minimized and contribution bases are maximized. For example, a combined approach might lead to the following result:

Optimizing the Pension Contribution FICA Efficient	*Earned Income Necessary*				*Results In*	
	Husband	Wife	Total		Pension Contribution	Payroll Taxes
401(k) elective deferral wage	15,500	15,500	31,000	Elective (100%)	31,000	4,743
Catch -up Election wage	5,000	5,000	10,000	Catch up (100%)	10,000	1,530
Normal Living Expenses	30,000	10,000	40,000			
	50,500	30,500	81,000	Employer (25%)	20,250	
Defined Benefit Plan contribution sufficient to pay				Defined Contribution	61,250	6,273
90% of salary for life	45,450	27,450	72,900	Defined Benefit	72,900	
						4.7%
				Funded	134,150	

The funding efficiency is 4.7 % in excess FICA for pension contribution

> **Note.** The final regulations require that the annual additions to a defined contribution plan not exceed $45,000. Those annual additions are employee elective deferrals, catch-up contributions, employer contributions, and forfeitures.[27] Care must be taken to ensure the plan's total annual additions do not exceed the allowed limit.

A reason to use differing plans is to maximize the contribution using FICA efficiency. There is less advantage in paying 15.3% in FICA taxes to enable the contribution, and then paying 15% income taxes when the funds are withdrawn from the plan. Furthermore, it is not reasonable to fund a qualified plan while paying 15.3% FICA taxes if the funds can remain in the corporation where they will be taxed at 15% capital gains rates when they became part of a sale or liquidation.

Defined contribution plans require actuarial services, plan documents, and annual Form 5500 reporting. This includes a Schedule B containing actuarial certification. Expenses can range from $2,200 to $4,500 for actuarial services, plan documents, and tax filing. However, these plans can defer a substantial amount of taxes.

KEOGH/HR 10 PLANS

The first retirement plans that allowed self-employed individuals to contribute to a tax-deferred retirement plan were called Keogh plans (commonly called HR 10 plans). These are small business plans named for the legislation's sponsor and the House of Representatives' bill responsible for their creation. With the introduction of many new types of self-employed retirement plans, Keogh plans have been used less frequently.

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27. Treas. Reg. §1.415(c)-1

DISTRIBUTION RULES

The distribution rules for all available **qualified** plans can be broken down into two methods:

1. Required minimum distribution rules (RMD), and
2. Simplified rules under IRS Pub. 575, *Pension and Annuity Income.*

Nonqualified plans follow a separate set of rules because there may be unrecovered basis, or after-tax contributions. These rules are shown in IRS Pub. 939, *General Rule for Pensions and Annuities.*

Distributions from most retirement plans must begin by April 1 of the year following the year the participant becomes 70½. Waiting until April to take a distribution will require taking two distributions in one year. Failure to take the RMD results in the IRS assessing a 50% excise tax on the difference between the distribution taken and the RMD.

> **Example 12.** Buzz turned 70½ on August 8, 2007. He must make a minimum distribution by April 1, 2008, or incur an excise tax penalty of 50%. He must also take an additional distribution by December 31, 2008, based on his balance on December 31, 2007.

IRA owners may aggregate the IRA balances of separate IRAs and meet the RMD rules. This usually requires communication to all custodians to avoid confusion. However, once an account is in payout status, the IRA custodian usually makes the RMD from any account being closed. This is because the custodian has a fiduciary duty and could be held liable for the excise tax if the beneficiary does not make the RMD in any account. If the taxpayer plans to move an IRA later in the year, and then plans for the RMD, he must overcome this problem or plan accordingly.

Form 5498, *IRA Contribution Information*, contains information in box 6 that is useful in determining basis in the IRA for reasons such as the inclusion of life insurance costs (PS 58 cost) in the participant's income in prior years. This PS 58 cost is the table value some taxpayers must include in income for company-sponsored retirement plans. Since the table value of the life insurance has been passed to the participant over the years on Form W-2, this amount is a recovery of basis on the payout of the IRA, and is generally not subject to tax because it is a recovery of cost.

☐ CORRECTED (if checked)

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 IRA contributions (other than amounts in boxes 2–4 and 8–10) $ 2 Rollover contributions $	OMB No. 1545-0747 2007 Form 5498	IRA Contribution Information
TRUSTEE'S or ISSUER'S federal identification no. / PARTICIPANT'S social security number	3 Roth IRA conversion amount $	4 Recharacterized contributions $	Copy B For Participant
PARTICIPANT'S name Street address (including apt. no.) City, state, and ZIP code	5 Fair market value of account $ 7 IRA ☐ SEP ☐	6 Life insurance cost included in box 1 $ SIMPLE ☐ Roth IRA ☐	This information is being furnished to the Internal Revenue Service.
	8 SEP contributions $	9 SIMPLE contributions $	
Account number (see instructions)	10 Roth IRA contributions $	11 If checked, required minimum distribution for 2008 ☐	

Form 5498 (keep for your records) Department of the Treasury - Internal Revenue Service

Calculation of the RMD for plans mentioned above is a very simple process. The contracts all have a zero basis, except possible PS 58 costs. Therefore, the RMD payout is only determined by the life expectancy from single or joint life tables. IRS Pub. 575 and the regulations refer to this method as the **Simplified Method.** The tables in IRS Pub. 575 are the Uniform Lifetime Table and the Joint and Last Survivor Table.

Determining life expectancy is the real task for determining the RMD under the Simplified Method. The participant facing retirement can choose to use the Uniform Lifetime Table if the individual is:

- Unmarried,
- Married, and his spouse is not the sole beneficiary; or
- Married, and his spouse is not more than 10 years younger.

All other users must use the Joint and Last Survivor Table to determine the appropriate life expectancy based on the following rules:

1. If distributions have begun, then the payment is made over the longer of the participant's life expectancy or the life expectancy of the beneficiary.
2. If the distributions have not begun prior to the participant's death, the entire amount is paid in five years. There are generous exceptions to the 5-year rule. The 5-year rule **does not** apply if:
   - Any portion of the distribution is payable to, or for the benefit of, a designated beneficiary. This occurs in almost all cases unless the estate is the beneficiary.
   - The portion of the entitled benefit is paid over the life expectancy of the beneficiary using the Uniform Lifetime Table, and begins within one year of death.
   - The beneficiary is the surviving spouse, and her portion will be paid out over the deceased spouse's life expectancy, or the surviving spouse's life expectancy, beginning on a date that the **decedent** would have been 70½.

Planning Tip. Because a distribution from a plan can be managed, lowering the amount of taxable social security (SS) benefits can save taxes at a favorable rate. This is because one dollar of income can create tax on pension income **and** 85% of SS benefits.

For 2007, taxpayers age 70½ or older can still direct IRA distributions to a qualified charity and avoid taxation. See Chapter 13, "Elder Issues," for more information on charitable contributions from an IRA.

Note. The RMD tables used when the taxpayer is age 70½ can be found in IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*, Appendix C for both single-life and joint-life situations. These tables are also found in Chapter 16, "Tax Rates and Useful Tables."

THE GENERAL RULE

The **General Rule** is used to determine distributions of **nonqualified** plans, other than complete cash-out distributions in one lump sum. Lump-sum distributions are reported on Form W-2 and noted in box 12. However, when an employer distributes an annuity in kind to a nonqualified deferred compensation participant (and not cash), the employer includes the annuity value at its fair market value and the participant is required to compute its taxability annually. Determining the taxable value is not simple.

Straight annuities, joint and survivor annuities, disability pensions, variable annuities, and certain life insurance are examples of investment contracts that have an undetermined payout. The General Rule is used to determine the taxable portion of the annuity distributed to the participant and the future taxation of the income stream.

Caution. Do not use the General Rule in IRS Pub. 939 *General Rules for Pensions and Annuities,* to compute the RMD from a **qualified plan** or IRA. Use the **Simplified Method** provided in IRS Pub. 575. Do not use the General Rule for life insurance proceeds paid on account of death, in which the taxpayer is a beneficiary. See IRS Pub. 525, *Taxable and Nontaxable Income,* for life insurance proceeds and the related settlement options.

The General Rule requires taxpayers to determine the taxability ratio of the investment in a contract. The steps to determine the ratio are:

1. Determine the investment in the contract, either in a lump sum or in installments paid to purchase the policy, and any amount of interest on which the taxpayer paid tax, if the policy paid taxable interest.
2. Subtract refunds, rebates, life insurance dividends, and policy loans that are not repaid on the policy.
3. Add any premiums paid for double indemnity or disability overages under the policy.
4. Subtract any contributions made while the taxpayer was a foreign worker, whose income was excluded from U.S. taxation in a pre-1963 or post-1962 grandfathered plan.
5. Add incidental ($5,000) death benefit exclusion used to fund the policy if the benefit was paid before the August 21, 1996 repeal.

The result is the net cost of the policy or its basis prior to a refund procedure. Once the net cost of the policy is determined, the exclusion ratio can be factored by comparing the net cost basis of the expected return of the policy.

Example 13. Bart's employer bought Bart and his wife a joint and survivor annuity for $50,000. When Bart left employment, he received the annuity with an FMV of $80,000. The $50,000 contribution of the employer and the $30,000 increase in valuation are shown on Bart's Form W-2 box 1, and listed with the appropriate code in box 12 as being nonqualified deferred compensation. John's "net cost" (tax basis) in the contract is $80,000.

The annuity will pay Bart $500 per month for his life. If he dies, it will pay $500 per month to his wife. The annuity starting date begins closest to Bart's 70th birthday. When Bart is age 70, his wife is 67 years old.

Bart consults the multiple Table VI in IRS Pub. 939 and finds the multiple for age 70 and 67 is 22.0:

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES TWO LIVES—EXPECTED RETURN MULTIPLES

AGES	65	66	67	68	69	70	71	72	73	74
65	25.0	24.6	24.2	23.8	23.4	23.1	22.8	22.5	22.2	22.0
66	24.6	24.1	23.7	23.3	22.9	22.5	22.2	21.9	21.6	21.4
67	24.2	23.7	23.2	22.8	22.4	22.0	21.7	21.3	21.0	20.8
68	23.8	23.3	22.8	22.3	21.9	21.5	21.2	20.8	20.5	20.2
69	23.4	22.9	22.4	21.9	21.5	21.1	20.7	20.3	20.0	19.6
70	23.1	22.5	22.0	21.5	21.1	20.6	20.2	19.8	19.4	19.1
[illegible]	[illegible]	22.2	21.7	21.2	[illegible]	20.2	19.8	[illegible]	[illegible]	[illegible]

The annual payments under the contract are (12 months × $500)	$ 6,000
The multiple annuity factor is 22.0	× 22.0
The expected payout of the annuity is the product result	$132,000

Because Bart's net basis in the annuity is $80,000, his exclusion ratio is 60.61% ($80,000 ÷ $132,000). If Bart or his wife die prior to using this basis, the deduction with respect to a decedent is taken on his final Form 1040.

STOCK OPTIONS

Some companies may award stock options to employees. While they are not technically a part of the retirement package, many of the options are exercised close to the time of retirement.

INCENTIVE STOCK OPTIONS

Statutory options are also known as incentive stock options (ISO).[28] Incentive stock options are treated as wages subject to ordinary income for the employee **if they are exercised and held less than one year. Those held more than one year after exercise are subject to capital gains rates.** Incentive options that are exercised and sold within the same tax year are not subject to alternative minimum tax (AMT). However, while ISOs exercised and sold in another year get the favorable capital gain rate (being held longer than one year), they are subject to AMT. Exercised and held ISOs have no regular tax basis, because they were not included in regular income when exercised and result in no regular income tax liability.

Deciding whether to delay exercising the ISO in order to obtain the favorable capital gain tax rate or exercise within one year and avoid the AMT can be a difficult decision for the tax planner. Utilization of the AMT exemption may be hindered in current and future periods, with future income creating a number of AMT issues. Finally, the availability of the minimum tax credit (supposedly a timing difference), may not reverse as quickly as the AMT exemption diminishes, especially with regular and AMT Schedule D calculations.

> **Note.** See Chapter 1, "Individual Taxpayer Problems," Issue 1, Example 1, for information regarding AMT and exercising an ISO.

NONQUALIFIED STOCK OPTIONS

Nonqualified stock options are options that do not conform to §422. These options result in ordinary income to the participant and are reported on Form W-2. Therefore, they have a basis for regular income tax and create no AMT themselves.

> **Caution.** ISO options become nonqualified options three months after termination from employment in accordance with §422(a)(2). Planners should be aware of this so that capital gain property does not become taxed at ordinary rates.

There have been many issues related to stock options, even prior to the recent backdating scandals noted in the press. The issuance of FASB 123[29] generated heated debate regarding how to measure stock options. While option exercise was recognized as a transaction for tax purposes between a company and employees, it was disregarded for book purposes, both when issued and when exercised, because it was outside the entity concept.

Subsequently, FASB 123R[30] was issued, requiring companies to use one of two methods to value options at the time of issue and later when stock appreciated. The first method allowed for the **intrinsic method.** Under this method, the cost of the option is only recognized when it is convertible to cash, whether exercised or left deferred. The second method was to recognize the time premium (some as long as 10 years) contained in options that are issued but are not yet convertible to cash or have not met the strike price. Valuation models such as Black-Scholes or binomial option pricing provided unreliable results, especially in the boom of the late 1990s.

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28. They get the statutory name because they are provided for in IRC §422.

29. Financial Accounting Standards Board Statement 123

30. Financial Accounting Standards Board Statement 123R (revised 2004)

STOCK APPRECIATION RIGHTS

The generous issuance of options led to shareholder scrutiny and a lot of diminished shareholder value through dilution of company stock. Further, as share prices fell at the beginning of the century, many executives found their exercised shares worthless after paying the exercise price and AMT. In an effort to align shareholder interest with employee compensation, stock appreciation rights (SAR) and phantom option plans are gaining in popularity.

SAR and phantom option plans are a synthetic measurement of the appreciation of a company's stock over a period of time. This measurement is reflected into cash compensation, subject to ordinary income tax. The employee is not required to fund exercise money, and therefore, these plans offer little downside over ISO and nonqualified plans. The ordinary income feature assures the avoidance of AMT. The execution date is controlled by the company, curtailing some of the FASB 123R issues that have plagued measurement of the offering of stock options. Essentially, the intrinsic method is the only valuation method under an SAR or phantom plan.

The primary difference between an SAR and a phantom stock plan is the basis of measurement:

- An SAR plan is based on the future appreciation and growth of the company's stock value since employment. These are used in existing companies with an established market valuation.
- Phantom option plans are based on total appreciation of a company's stock value because the company may not be publicly traded upon hiring. These are used in start-up companies that are seeking to stay private or make a public offering.

USERRA REQUIREMENTS

Due to the increase in the use of Guard and Reserve personnel to staff military operations, Congress acted to protect the retirement benefits of these individuals. The Uniform Services Employment and Reemployment Act (USERRA) was passed in 1994 to govern the reemployment of military service personnel called for active duty. The act applies to service persons who return to the reemployment position within 90 days of discharge. The act requires, among other things, the reemployment of military service personnel even if it requires laying off a replacement employee. It also has an escalator clause restoring promotions, position, and raises the service person missed after furlough. This act, while not designed to shift the cost of maintaining the armed forces to the private sector, was passed to restore the service person to the same position had he not had a leave of absence. Position, by class of employee, escalations, salary grade improvements in rate of pay, and bonus status seniority are determined as if the employee had not left the service of the employer. However, the service person does not receive any bonuses paid while on leave.

In the case of a **defined benefit plan,** USERRA requires the crediting of service time while the employee was away. Essentially, the funding of this is placed upon other plan participants sharing the company contribution with the service person. In the case of a **defined contribution plan,** any employer contribution not made while away in service must be contributed on reemployment to the extent that an elective deferral and employer match "catch-up" period must be offered to returning service persons. The company is not required to make employer contributions to a defined contribution plan while the participant was away in service as if he had never left employment. The treatment of health plans is similar to the federal COBRA rules, which permit a 24-month payment for the employee contribution upon leaving for service employment, and a return without pre-existing condition, except for conditions incurred while on duty. Again the employer is not required to maintain coverage while a service person is away on active duty.

The Employer Support of the Guard and Reserve (ESGR) provides free legal counseling to employers regarding questions about USERRA with locations in every county in the country. The ESGR will also arbitrate grievances between employers and returning service personnel regarding each one's rights under the act.

> **Note.** Comprehensive coverage of the USERRA is found in the 2006 *University of Illinois Federal Tax Workbook* on pages 219–224.

HEALTH PLANS AND RETIREMENT

Health plan costs are increasing at rates far in excess of the cost of living. Consequently, employers are questioning their role in providing employer-based health care. Throughout the 1990s and into the 21st century, escalating health care costs led benefit managers to change plan design, shifting the burden of utilization to employees and limiting the cost of health care. These efforts led to installing health care account-balance plans, resembling the defined contribution revolution in the pension area. Traditional defined benefit health care plans that covered employees and retirees for life first became an issue with the issuance of FASB 112, *Employers' Accounting for Post Employment Benefits*, issued November 1992. This FASB and related Statement of Position 92-5 (SOP 92-5) require company disclosure of benefits liability when earned, not on the pay-as-you-go method when the benefit is paid.

Couples retiring in 2006 are expected to spend $295,000 on health care plans over their life expectancy. This is in addition to coverage provided under Medicare and employer plans.[31] This results when only 32% of companies plan to offer post-employer health care to retirees.

Furthermore, the $295,000 excludes long-term health care. It is estimated that 36% of healthy retirees will need long-term care benefits. The cost distribution for long-term care for retirees is estimated to be as follows:

- 64% will not incur any nursing home costs
- 7% will spend less than $50,000
- 6% will spend between $50,000 and $100,000
- 12% will spend between $100,000 and $250,000
- 11% will spend over $250,000

With such a range of frequency and cost disparity, insurance may be the prudent answer to this problem. Insurance can mitigate the risk at an affordable cost.

Medicare provides Part A (hospital) and Part B (medical) coverage. Medicare Part C, also known as Choice or Advantage plans, is used to the exclusion of Parts A and B in a Preferred Provider Organization or Health Maintenance Organization delivery system. Medicare Part D provides for prescription drug plans coverage and discounts.

31. Employee Benefit Research Institute as quoted in *National Underwriters Life*, July 20, 2006.

Cost-sharing	What YOU PAY in 2007 (These amounts can change each year.)	Medigap policies that may help pay all or some of these costs
Medicare Part A Coinsurance and Hospital Benefits	**For each benefit period, YOU PAY** • $248 per day for days 61–90. • $496 per day for days 91–150 (while using your 60 lifetime reserve days).	Medigap Plans A, B, C, D, E, F, G, H, I, J, K, or L
Medicare Part B Coinsurance or Copayment	**YOU PAY** all coinsurance, generally 20% of the Medicare-approved amounts for most covered services and any copayment **after** you meet the $131 yearly Part B deductible.	Medigap Plans A, B, C, D, E, F, G, H, I, J, K, or L
Blood	Generally, **YOU PAY** for the first three pints of blood.	Medigap Plans A, B, C, D, E, F, G, H, I, J, K, or L
Hospice Care Coinsurance or Copayment	**YOU PAY** a coinsurance or copayment, up to $5 for inpatient drugs and 5% of the Medicare-approved amount for inpatient respite care.	Medigap Plans K or L
Skilled Nursing Facility Care Coinsurance	**For each benefit period, YOU PAY** • nothing for the first 20 days. • up to $124 per day for days 21–100.	Medigap Plans C, D, E, F, G, H, I, J, K, or L
Medicare Part A Deductible	**For each benefit period, YOU PAY** • $992 for days 1–60 of a hospital stay.	Medigap Plans B, C, D, E, F, G, H, I, J, K, or L
Medicare Part B Deductible	**YOU PAY** the $131 yearly deductible.	Medigap Plans C, F, or J
Medicare Part B Excess Charges	**YOU PAY** the difference between the Medicare-approved amount and the limiting charge (no more than 15% above the Medicare-approved amount).	Medigap Plans F, G, I, or J
Foreign Travel Emergency	Generally, **YOU PAY** all costs.	Medigap Plans C, D, E, F, G, H, I, or J
At-Home Recovery	**YOU PAY** • $0 for Medicare-approved home health services. • 100% for services not covered by Medicare.	Medigap Plans D, G, I, or J
Preventive Care Coinsurance	Generally, **YOU PAY** all costs.	Medigap Plans A, B, C, D, E, F, G, H, I, J, K, or L
Preventive Care not covered by Medicare	**YOU PAY** all costs.	Medigap Plans E or J

Medicare does not cover all the cost of post-retirement health care. Participants can choose Medigap coverage from 12 standardized plans (A through L) for those uncovered items; however, participants still face out-of-pocket costs. Medigap policies are not necessary for Part C plans.

Similar to establishing IRAs in 1978, Congress established various programs to provide for tax-deferred savings for medical expenses beyond the framework of pension plans.

Medical reimbursement plans are available to corporate employees under §213. Medical reimbursement plans are employer-paid plans that are very popular with one-person corporations because it can provide deductible heath insurance and medical reimbursement without the inclusion of those benefits in federal income, social security, or state income taxes. The disadvantage of this program is a **comparability** feature that only allows discrimination of coverage between full-time, part-time, and past classification of employees. This wall-to-wall coverage provides for escalated costs as additional employees became eligible to participate.

Flexible spending medical reimbursement offered under the cafeteria plan[32] provides a way for employers to offer benefits on an elective deferral basis. This improves the wall-to-wall coverage problem, because employees contribute all, part, or match contributions to the plan. The employer who participates in the plan has to meet certain comparability rules and pass discrimination testing. Participants are subject to the use-it-or-lose-it forfeiture provisions, which have now been improved, allowing reimbursements up to two and one-half months after the plan year end. However, flexible spending arrangements do not allow the purchase of long-term care insurance with plan funds.

32. IRC §125

Observation. The insurance lobby was particularly insistent about this provision, and lobbied heavily for maintaining this feature. They reason that the adverse selection issue (healthy people build account balances, unhealthy people purchase insurance) is a great risk in offering these types of plans. Accordingly, they believed participants "had to have something to lose," making this feature more like insurance. Owner/employees care less about forfeitures, since the forfeitures are made back to the company.

Medical (Archer) savings accounts (MSA) were added by HIPPA in 1996 as an experiment of a true allowable defined contribution health savings plan. The experiment originally limited the number of plans nationwide to 750,000. On May 7, 2007, the IRS announced the cut-off amount had not been achieved[33] and only 20,361 MSAs existed in 2006. Obviously, the experiment is not going well because the plan is limited to the self-employed, its funding limitations are strict, and the funding by the employer, employee, or both, is inflexible. Most MSAs are being transferred to health savings accounts (HSA) in a direct institution-to-institution rollover on a tax-free basis.

Health savings accounts (HSA) offer flexibility, portability, and broad eligibility to more participants. After adopting a high deductible health plan (HDHP) containing statutory limits, the participant or his family can contribute as follows:

2007 HSA Cost-of-Living Adjustments and Requirements

	Individual	Family
Minimum deductible	$1,100	$ 2,200
Maximum contribution	2,850	5,650
Age 55 to 65 catch-up contribution	800	800 each
Maximum out-of-pocket expenses	5,500	11,000

Note. See Chapter 1, "Individual Taxpayer Problems," Problem 2, for more information on HSAs.

Certain limitations apply to the use of other insurance policies in addition to the HDHP policy that qualifies a participant for an HSA. Generally, special disease coverage that offer a per diem reimbursement,[34] accident policies, disability, vision, dental, or long-term care policies are still allowed in combination with HDHP policies.

Qualified expenses available to be paid from HSAs include any qualifying medical expense allowed under §213(d).[35] This includes insurance premiums (including long-term care insurance), Medicare A, B, or C and Part D prescription drug costs, hearing, vision, special education, medical housing, dental care, mental health care, preventative care, prenatal care, smoking cessation, weight loss, and even lead-based paint removal. Expenses such as cosmetic surgery, illegal treatments, general fitness health clubs, and over-the-counter prescriptions[36] are not allowed.

Investments by the HSA custodian can be in any general asset class except collectibles and life insurance. The HSA cannot be used as collateral for a loan or any of the prohibited transactions listed in §4975.

33. Announcement 2007-44, 2007-19 IRB 1238

34. Such as a cancer policy paying a fixed rate per day

35. Diagnosis, cure, mitigation, treatment, and prevention as allowed as a medical expense on Schedule A

36. Over-the-counter is allowed for flexible spending account purposes.

There are many positive features in the HSAs, and some drawbacks:

- Funding is not allowed when covered by Medicare because it is not an HDHP.
- Active and retired military cannot make contributions if they are covered under TRICARE or the VA Health Program because these are not HDHPs.
- Upon the death of the owner, any unused funds not left to a surviving spouse are taxable income. If the estate is the beneficiary, or the HSA fails to appoint a beneficiary, the HSA can use the funds to pay medical expenses incurred prior to death.

The following table illustrates the tax savings from making HSA contributions.

HSA Tax Savings
Reduction in Federal Income Tax from HSA Contributions in 2006
Illustrative Examples

HSA Contribution	Income $20,000	$40,000	$60,000	$80,000	$100,000	$120,000
Single taxpayer						
$ 500	75	75	125	125	140	140
1,000	150	150	250	250	280	280
1,500	225	225	375	375	420	420
2,000	300	300	500	500	560	560
2,500	375	375	625	625	700	700
2,700	405	405	675	675	756	756
Head of household with 1 dependent child						
$1,000	100	150	250	300	260	260
2,000	200	300	455	600	520	520
3,000	300	450	605	900	780	780
4,000	400	600	755	1,200	1,040	1,040
5,000	500	750	905	1,500	1,300	1,300
5,450	545	817	973	1,613	1,417	1,417
Married couple with no dependents						
$1,000	100	150	150	150	250	260
2,000	200	300	300	300	500	520
3,000	300	450	450	450	750	780
4,000	310	600	600	600	1,000	1,040
5,000	310	750	750	750	1,250	1,300
5,450	310	817	817	817	1,362	1,417
Married couple with 2 dependent children						
$1,000	0	150	150	150	260	310
2,000	0	270	300	300	520	620
3,000	0	370	450	450	780	930
4,000	0	470	600	600	1,040	1,240
5,000	0	570	750	750	1,300	1,550
5,450	0	615	817	817	1,417	1,667

SPECIAL RETIREMENT PLANNING ISSUES

Qualified domestic relations orders (QDRO) were originally designed to split the marital interest in qualified plans between husband and wife. The court's authority over the marital portion of the participant's qualified plan is used in unique ways. QDROs are often used in delinquent child support situations, especially by public aid and public relief agencies to collect back child support or to mitigate public aid paid under ADC as assistance to children.

A qualified medical child support orders (QMCSO) is an order issued by a state court, child support, or public aid agency. The QMCSO creates a mechanism for a health care plan to provide benefits to an alternate payee for which a participant or beneficiary is eligible to receive under a group health plan. QMCSOs were added to Section 609 of ERISA and Section 1908 of the Social Security Act to require:

- Health insurers to enroll a child under his parent's health insurance. This is required even if the child was born out of wedlock, does not reside with the insured parent or in the insured's service area, or is not claimed as a dependent on the parent's federal income tax return.
- Health insurers to enroll a child under a court or administrative order, without regard to the plan's open enrollment restrictions.
- Employers and insurers to comply with court administrative orders requiring the parent to provide health coverage for a child.
- Insurers to permit a custodial parent to file claims on behalf of his child under the noncustodial parent's health insurance and to make benefit payments to the custodial parent or health care provider.

For example, qualified Illinois domestic relations order (QILDRO) is a state law that provides a similar responsibility of a QDRO under federal law for ERISA plans. Qualified plans are not always ERISA plans under the separation of state and federal government. Therefore, QDROs were not effective against state plans because they are not covered by ERISA. Anyone who accepts employment with 15 various state retirement systems in Illinois is required to comply when a QILDRO is issued.[37]

RECENT CHANGES

NEW FORM W-4P

Beginning in 2007, the IRS issued a new Form W-4P, *Withholding Certificate for Pension or Annuity Payments.* The revised Form W-4P allows the recipient to calculate the number of exemptions he wishes to claim based on his projected income from all sources. The form is similar to the Form W-4 used by wage earners.

Taxpayers may still choose to have no withholdings from their pension distributions and include this income in their quarterly estimated payments. The 2007 Form W-4P is shown below.

37. These plans include the State University Retirement System, Illinois Municipal Retirement System, Teachers Retirement System, Judges Retirement System, General Assembly Retirement System, State Employees Retirement System, Police Annuity and Benefit Fund, and Park District Annuity and Benefit Fund.

Form **W-4P**
Department of the Treasury
Internal Revenue Service

Withholding Certificate for Pension or Annuity Payments

OMB No. 1545-0074
2007

Purpose. Form W-4P is for U.S. citizens, resident aliens, or their estates who are recipients of pensions, annuities (including commercial annuities), and certain other deferred compensation. Use Form W-4P to tell payers the correct amount of federal income tax to withhold from your payment(s). You also may use Form W-4P to choose (a) not to have any federal income tax withheld from the payment (except for eligible rollover distributions, or payments to U.S. citizens delivered outside the United States or its possessions) or (b) to have an additional amount of tax withheld.

Your options depend on whether the payment is periodic, nonperiodic, or an eligible rollover distribution, as explained on pages 3 and 4. Your previously filed Form W-4P will remain in effect if you do not file a Form W-4P for 2007.

What do I need to do? Complete lines **A** through **G** of the **Personal Allowances Worksheet**. Use the additional worksheets on page 2 to adjust your withholding allowances for itemized deductions, adjustments to income, certain credits, or multiple pensions/more-than-one-income situations. If you do not want any federal income tax withheld (see *Purpose* above), you can skip the worksheets and go directly to the Form W-4P below.

Sign this form. Form W-4P is not valid unless you sign it.

Personal Allowances Worksheet (Keep for your records.)

A Enter "1" for **yourself** if no one else can claim you as a dependent . . . . **A** ______

B Enter "1" if:
- You are single and have only one pension; or
- You are married, have only one pension, and your spouse has no income subject to withholding; or
- Your income from a second pension or a job, or your spouse's pension or wages (or the total of all) is $1,000 or less.

. . . . **B** ______

C Enter "1" for your **spouse**. But, you may choose to enter "-0-" if you are married and have either a spouse who has income subject to withholding or you have more than one source of income subject to withholding. (Entering "-0-" may help you avoid having too little tax withheld.) . . . . **C** ______

D Enter number of **dependents** (other than your spouse or yourself) you will claim on your tax return . . . . **D** ______

E Enter "1" if you will file as **head of household** on your tax return . . . . **E** ______

F **Child Tax Credit** (including additional child tax credit):
- If your total income will be less than $57,000 ($85,000 if married), enter "2" for each eligible child.
- If your total income will be between $57,000 and $84,000 ($85,000 and $119,000 if married), enter "1" for each eligible child plus "1" **additional** if you have 4 or more eligible children . . . . **F** ______

G Add lines A through F and enter total here. (**Note.** *This may be different from the number of exemptions you claim on your tax return.)* . . . . ▶ **G** ______

For accuracy, **complete all worksheets that apply.**
- If you plan to **itemize or claim adjustments to income** and want to reduce your withholding, see the **Deductions and Adjustments Worksheet** on page 2.
- If you have more than one source of income subject to withholding or a spouse with income subject to withholding **and** your combined income from all sources exceeds $40,000 ($25,000 if married), see the **Multiple Pensions/More-Than-One-Income Worksheet** on page 2 to avoid having too little tax withheld.
- If **neither** of the above situations applies, **stop here** and enter the number from line G on line 2 of Form W-4P below.

------------ **Cut here and give Form W-4P to the payer of your pension or annuity. Keep the top part for your records.** ------------

Form **W-4P**
Department of the Treasury
Internal Revenue Service

Withholding Certificate for Pension or Annuity Payments

▶ **For Privacy Act and Paperwork Reduction Act Notice, see page 4.**

OMB No. 1545-0074
2007

Type or print your first name and middle initial.	Last name	Your social security number
Home address (number and street or rural route)		Claim or identification number (if any) of your pension or annuity contract
City or town, state, and ZIP code		

Complete the following applicable lines.

1 Check here if you **do not want any** federal income tax withheld from your pension or annuity. (Do not complete lines 2 or 3.) ▶ ☐

2 Total number of allowances and marital status you are claiming for withholding from each **periodic** pension or annuity payment. (You may also designate an additional dollar amount on line 3.) . . . . ▶ ______ (Enter number of allowances.)

Marital status: ☐ Single ☐ Married ☐ Married, but withhold at higher "Single" rate

3 Additional amount, if any, you want withheld from each pension or annuity payment. (**Note.** *For periodic payments, you cannot enter an amount here without entering the number (including zero) of allowances on line 2.)* . . . ▶ $

Your signature ▶ **Date** ▶

Cat. No. 10225T Form **W-4P** (2007)

Form W-4P (2007) Page **2**

Deductions and Adjustments Worksheet

Note. *Use this worksheet **only** if you plan to itemize deductions, claim certain credits, or claim adjustments to income on your 2007 tax return.*

1 Enter an estimate of your 2007 itemized deductions. These include qualifying home mortgage interest, charitable contributions, state and local taxes, medical expenses in excess of 7.5% of your income, and miscellaneous deductions. (For 2007, you may have to reduce your itemized deductions if your income is over $156,400 ($78,200 if married filing separately). See *Worksheet 2* in Pub. 919 for details.) . . **1** $______

2 Enter: { $10,700 if married filing jointly or qualifying widow(er); $ 7,850 if head of household; $ 5,350 if single or married filing separately } . . . . **2** $______

3 **Subtract** line 2 from line 1. If zero or less, enter "-0-" . . . . **3** $______

4 Enter an estimate of your 2007 adjustments to income, including alimony, deductible IRA contributions, and student loan interest . . . . **4** $______

5 **Add** lines 3 and 4 and enter the total. (Include any credit amounts from *Worksheet 8* in Pub. 919.) . **5** $______

6 Enter an estimate of your 2007 income not subject to withholding (such as dividends or interest) . . **6** $______

7 **Subtract** line 6 from line 5. If zero or less, enter "-0-" . . . . **7** $______

8 **Divide** the amount on line 7 by $3,400 and enter the result here. Drop any fraction . . . . **8** ______

9 Enter the number from the **Personal Allowances Worksheet,** line G, page 1 . . . . **9** ______

10 **Add** lines 8 and 9 and enter the total here. If you use the **Multiple Pensions/More-Than-One-Income Worksheet,** also enter this total on line 1 below. Otherwise, **stop here** and enter this total on Form W-4P, line 2, page 1 . . . . **10**

Multiple Pensions/More-Than-One-Income Worksheet

Note. *Complete only if the instructions under line G, page 1, direct you here. This applies if you (and your spouse if married filing a joint return) have more than one source of income subject to withholding (such as more than one pension, or a pension and a job, or you have a pension and your spouse works).*

1 Enter the number from line G, page 1 (or from line 10 above if you used the **Deductions and Adjustments Worksheet**) . . . . **1** ______

2 Find the number in **Table 1** below that applies to the **LOWEST** paying pension or job and enter it here. **However**, if you are married filing jointly and the amount from the highest paying pension or job is $50,000 or less, do not enter more than "3." . . . . **2** ______

3 If line 1 is **more than or equal to** line 2, subtract line 2 from line 1. Enter the result here (if zero, enter "-0-") and on Form W-4P, line 2, page 1. **Do not** use the rest of this worksheet . . . . **3** ______

Note. *If line 1 is **less than** line 2, enter "-0-" on Form W-4P, line 2, page 1. Complete lines 4–9 below to calculate the additional withholding amount necessary to avoid a year-end tax bill.*

4 Enter the number from line 2 of this worksheet . . . . **4** ______

5 Enter the number from line 1 of this worksheet . . . . **5** ______

6 **Subtract** line 5 from line 4 . . . . **6** ______

7 Find the amount in **Table 2** below that applies to the **HIGHEST** paying pension or job and enter it here **7** $______

8 **Multiply** line 7 by line 6 and enter the result here. This is the additional annual withholding needed . **8** $______

9 **Divide** line 8 by the number of pay periods remaining in 2007. For example, divide by 12 if you are paid every month and you complete this form in December 2006. Enter the result here and on Form W-4P, line 3, page 1. This is the additional amount to be withheld from each payment . . . . **9** $

Table 1

Married Filing Jointly		All Others	
If wages from **LOWEST** paying pension or job are—	Enter on line 2 above	If wages from **LOWEST** paying pension or job are—	Enter on line 2 above
$0 - $4,500	0	$0 - $6,000	0
4,501 - 9,000	1	6,001 - 12,000	1
9,001 - 18,000	2	12,001 - 19,000	2
18,001 - 22,000	3	19,001 - 26,000	3
22,001 - 26,000	4	26,001 - 35,000	4
26,001 - 32,000	5	35,001 - 50,000	5
32,001 - 38,000	6	50,001 - 65,000	6
38,001 - 46,000	7	65,001 - 80,000	7
46,001 - 55,000	8	80,001 - 90,000	8
55,001 - 60,000	9	90,001 - 120,000	9
60,001 - 65,000	10	120,001 and over	10
65,001 - 75,000	11		
75,001 - 95,000	12		
95,001 - 105,000	13		
105,001 - 120,000	14		
120,001 and over	15		

Table 2

Married Filing Jointly		All Others	
If wages from **HIGHEST** paying pension or job are—	Enter on line 7 above	If wages from **HIGHEST** paying pension or job are—	Enter on line 7 above
$0 - $65,000	$510	$0 - $35,000	$510
65,001 - 120,000	850	35,001 - 80,000	850
120,001 - 170,000	950	80,001 - 150,000	950
170,001 - 300,000	1,120	150,001 - 340,000	1,120
300,001 and over	1,190	340,001 and over	1,190

NOTICE 2007-7

The IRS released Notice 2007-7 on January 10, 2007. The notice provides guidance on several provisions in the Pension Protection Act of 2006. It includes guidance on:

- Early distributions from qualified plans to terminated public safety employees;
- Hardship distributions;
- Rollovers from qualified plans to IRAs for nonspousal beneficiaries and distributions to pay for health insurance for retired public safety officers;
- Taxpayers age $70^1/_2$ and older directly transferring up to $100,000 per year from their IRA to a qualified charity and having that distribution qualify as the RMD for the participant;
- Earlier vesting of certain employer contributions; and
- Interest rate assumptions for lump-sum distributions.

FORM 5500 SCHEDULE P NOT REQUIRED

In IRS Announcement 2007-63, June 29, 2007, the IRS determined that the use of Schedule P, *Annual Return of Fiduciary Benefit Trust,* in connection with filing the Form 5500, was no longer necessary. The IRS is attempting to transition all Form 5500 files to electronic filing. Eliminating the Schedule P will reduce the burden on employers, plan administrators, trustees, and custodians.